IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

NO. 18-0121

DALE W. STEAGER, WEST VIRGINIA
STATE TAX COMMISSIONER,

Respondent below, Petitioner

vs.

CONSOL ENERGY, INC., DBA
CNX GAS COMPANY, LLC,

Petitioner below, Respondent.

REPLY BRIEF OF
WEST VIRGINIA STATE TAX DEPARTMENT

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I. ARGUMENT

A. THE TAX DEPARTMENT CORRECTLY APPLIED THE LEGISLATIVE RULE IN VALUING CNX GAS'S PRODUCING OIL AND GAS WELLS CONTRARY TO THE BUSINESS COURT DECISION.

Facts matter. The law matters. Every tax case is dependent on the facts before the Court and the applicable law of the particular tax statutes at issue. The Tax Department's appeal of the five erroneous decisions issued by the Business Court Division is no different. CNX Gas Company, LLC, (hereinafter CNX or CNX Gas) raised several objections before the Supreme Court which will be addressed below. Each of CNX's objections ignores both the material facts and the law.

A.1. The Tax Department Performed the Two Critical Functions Required by the Legislative Rule.

While operating a horizontal oil and gas well is a complex undertaking, the valuation process for ad valorem tax purposes is fairly simple. The primary objective in valuing natural resource properties is set forth by statute. W.Va. Code § 11-6K-1(a) (2010) states in its entirety, "(a) All industrial property and natural resources property shall be assessed annually as of the assessment date at sixty percent of its true and actual value."

However, the mechanics of the valuation process are outlined in the legislative rule. Every individual oil and gas well is valued according to the Yield Capitalization Model set forth in the legislative rule. *See* W.Va. Code R. § 110-1J-4.6. Gross receipts are reduced by the average annual industry operating expenses. The legislative rule requires the Tax Department to determine the standard deduction to be utilized in valuing operating oil and gas wells every five years.

> 4.3. Average industry operating expenses. -- The Tax Commissioner **shall every five (5) years, <u>determine</u>** the average annual industry operating expenses per well. **The average annual industry operating expenses <u>shall be deducted</u>** from working interest gross receipts to develop an income stream for application of a yield capitalization procedure.

W.Va. Code R. § 110-1J-4.3 (emphasis added). The legislative rule cannot be clearer.

The Tax Department is required to perform two critical functions according to the legislative rule. First, the Tax Department is required to determine the Average Annual Industry Operating Expense every five years for ad valorem tax purposes. In 2014 the Tax Department circulated a survey among all oil and gas producers in this State and calculated the Average Annual Industry Operating Expense based on the data submitted by the industry. The data supplied by CNX was included in that calculation. Second, the Tax Department is required to deduct the Average Annual Industry Operating Expense from the gross receipts in valuing every producing oil and gas well in West Virginia under the Yield Capitalization Model.

The Tax Department performed the two critical functions it is required to perform under the legislative rule in valuing CNX's producing oil and gas wells. The Tax Department valued every producing oil and gas well in West Virginia using the exact same procedures for the 2016 TY as it used in valuing CNX's producing oil and gas wells.

A.2. The Tax Department Did Not Artificially "Cap" the Average Annual Industry Operating Expense Contrary to CNX's Assertions.

CNX advanced its appeal in the Business Court by repeatedly stating the Average Annual Industry Operating Expense backwards. CNX Gas argues that "...the Tax Department erroneously calculated average operating expenses of 30% of gross receipts with a 'cap' of $5,000 per well for tax year 2016..." *See CNX's Supreme Court Brief* at p. 5. Repeatedly, CNX argues that the Average Annual Industry Operating Expense of 30% of gross receipts has been limited to, capped at, or set at a maximum amount of $5,000 per well by the Tax Department. *See e.g., CNX's Supreme Court Brief* at pp. 1, 3, 4, 6, 7, 17, 18, 19, 20, 21, 22, 23, and 25. CNX summarized its entire argument in Footnote 56 of the *Supreme Court Brief*, stating "...that the cap is unsupported by law as it artificially limits the amount of the operating expenses allowed per well..." The Tax Department used the results from the 2014 industry survey, not a "cap".

The Tax Department admits that the definition of Average Annual Industry Operating Expense in the legislative rule does not include the words "cap" or "maximum amount" as argued by CNX. By the same token, the definition does not include the words "percentage" or "unlimited deductions" as advocated by CNX. Nor does the legislative rule specifically state that the Tax Department must determine "...a single average to be applied as a percentage..." as ruled by the Business Court. *See* AR 0006; *see* also CNX's Supreme Court Brief at p. 16 (single average).

CNX's objection regarding any "cap" ignores the testimony presented at the Board of Assessment Appeals hearings by the Tax Department. Cindi Hoover of the Property Tax Division

testified at the Board of Assessment Appeals hearing in October 2016 regarding the Average Annual Industry Operating Expense as it relates to a percentage to gross receipts.

At the Lewis County Board of Assessment Appeals hearing in October 2016, Cindi Hoover of the Property Tax Division testified that the $5,000 expense figure was based on the survey of oil and gas producers from 2014. *See* AR Vol. III, Trans. at p. 36-37. On cross-examination, Ms. Hoover stated that although the legislative rule does not include the word "cap" or "maximum amount", the rule uses the word "average." *See* AR Vol. III, Trans. at p. 37-38.[1]

Consequently, the Tax Department expressed the Average Annual Industry Operating Expense as 30% of gross receipts not to exceed $5,000 per well for the 2016 TY because those were the numbers calculated from the data supplied by the oil and gas producers in the 2014 survey. The Tax Department has simply expressed the same calculation in two different ways; 30% of gross receipts not to exceed $5,000 per well. In short, 1 foot equals 12 inches.

By first calculating the average of the actual dollar amount of the reported operating expenses based on the survey, the Tax Department was able to observe the relationship between reported operating expenses and reported gross receipts for the entire industry as of May and June in 2014. The Tax Department did not "artificially cap" the deduction or set a maximum amount for the deduction as CNX argues; the deduction of approximately $5,000 per well was the average operating expense reported by the industry on the 2014 survey as Cindi Hoover testified in October of 2016.

[1] The testimony of the witnesses varies among the several Board of Assessment Appeal hearings for the 2016 TY. Ms. Hoover provided better testimony regarding the relationship between the dollar amount of the Average Annual Industry Operating Expense and the percentage deduction in the Doddridge County appeal for CNX Gas. Ms. Hoover's testimony is quoted in the Tax Department's Reply brief in the Doddridge County appeal of *Steager v. CNX Gas*, Supreme Court Appeal No. 18-0123, AR Vol. III, 2016 Transcript at p. 54:11 – 56:15 and also p. 65:2 – 24.

This is far more than a semantic issue. By misstating the deduction, CNX has attempted to hide the relationship between the dollar amount of reported expenses per well and the gross receipts per well revealed by the industry data. According to Ms. Hoover's testimony, the percentage deduction utilized by the Tax Department reflects the relationship between the dollar amount of reported operating expenses and the dollar amount of gross receipts reported by the industry in 2014. The dollar amount reported for average operating expenses of approximately $5,000 per well was also roughly 30% of the gross receipts reported by the oil and gas producers in 2014. Therefore, the Tax Department utilized an Average Annual Industry Operating Expense of 30% of gross receipts not to exceed $5,000 per well to value every producing oil and gas well.

CNX's primary objection is that CNX is not satisfied with the Average Annual Industry Operating Expense of 30% of gross receipts not to exceed $5,000 per well for the 2016 TY. Simply put, CNX wants a larger deduction for ad valorem property tax purposes. The logic is obvious from CNX's perspective. If a larger deduction is authorized, the valuation of CNX's 863 producing oil and gas wells in Lewis County for the 2016 TY will be reduced. A reduced valuation will result in CNX Gas paying less in property taxes in Doddridge County, Lewis County, McDowell County, and every West Virginia County, where CNX operates oil and gas wells.

However, CNX cannot claim a deduction of greater than $5,000 per well for the 2016 TY because alternative deductions are not authorized under the legislative rule. No producer is authorized to claim his alleged actual operating expenses. The legislative rule is clear regarding authorized deductions for ad valorem tax purposes. In order to value producing oil and gas wells "...the average annual industry operating expenses shall be deducted..." from the working interest gross receipts. W.Va. Code R. § 110-1J-4.3. CNX Gas received the Average Annual Industry

Operating Expense of 30% of gross receipts not to exceed $5,000 per well when the Tax Department valued all of CNX's oil and gas wells.

A.3. The Ad Valorem Property Tax is a Different Tax than the Severance Tax Or the Corporate Net Income Tax.

CNX argues that it should be allowed to deduct its alleged actual operating expenses incurred to create the gross receipts which must be reported for ad valorem property tax valuation purposes. Specifically, CNX "… contends that use of its actual operating expenses represents the best method to determine the fair market value for its producing wells, as required…" *CNX's Supreme Court Brief* at p. 17. CNX repeatedly argues that "… any operating expenses incurred between the wellhead and the field line point of sale should be used to value the well." *See, e.g., CNX's Supreme Court Brief* at pp. 13 and Footnote 59. In short, CNX argues that the expenses incurred in getting the gas and oil out of the ground and the transportation expenses to get the gas to market should be an allowed deduction for ad valorem tax purposes. The Business Court adopted CNX's rationale and ruled that "… this 'cap" unduly restricts the amount of operating expenses that should be allowed for each well…" Business Court Decision at AR 0006.

CNX is attempting to claim deductions under the ad valorem property tax structure that were created by the Legislature specifically for the Corporate Net Income Tax and the Severance Tax. Different taxes operate differently. Throughout this entire litigation, the Tax Department has taken a straight forward approach to the case. The legislative rule only authorizes the standard deduction of the Average Annual Industry Operating Expense which is calculated every five years. *See* W.Va. Code R. § 110-1J-4.3. No alternative deductions are authorized for ad valorem property tax purposes under the legislative rule or the statutory framework.

However, CNX demands a deduction that is not authorized. In Footnote 59 of its *Supreme Court Brief*, CNX references the deductions under the Severance Tax to support its demand

deductions under the ad valorem property tax. However, Footnote 59 actually confirms the Tax Department's argument that only a standard deduction is authorized under the ad valorem property tax structure at issue in the case before the Supreme Court.

The Severance Tax is imposed at the rate of 5% of the "gross value" of the natural resource produced and measured at the wellhead and the Severance Tax statute expressly excludes transportation and transmission expenses incurred by the producers to get the natural resources to market. W. Va. Code § 11-13A-2(c) (6)(G) (2004)[2] (emphasis added) states that producers shall report "gross value" as "[f]or natural gas, gross value is the value of the natural gas at the wellhead **immediately preceding transportation and transmission.**"

CNX Gas specifically cited to legislative rules for the Severance Tax authorizing natural gas producers to deduct 15% of the gross proceeds for Severance Tax purposes as a substitute for actual transmission costs when the natural gas is sold at a point away from the wellhead.

> 4.8.4. As an alternative to the methods presented at Subsections 4.8.4 [*sic*] through 4.8.3 supra, the well-mouth value of such severance and production of natural gas **not sold at the well-mouth** may be determined by a deduction of transportation and transmission costs **in the amount of 15% of the gross proceeds** of the natural gas severed and produced.

W. Va. Code R. § 110-13A-4.8.4 (1992). There is no comparable percentage deduction to be found in the legislative rule for the ad valorem property tax.

Clearly, the case before the Supreme Court is an ad valorem property tax case and **not** a Severance Tax case or a Corporate Net Income Tax case. Certainly, the West Virginia Legislature could have authorized deductions for post-production expenses including gathering and

[2] The language in Subsection 2(c)(6)(G) is identical to the language found in W. Va. Code § 11-13A-2(b)(6)(G) (1987 Replacement Volume). The definitions to the Severance Tax were renumbered in 1995; however, the language regarding the valuation of natural gas at the wellhead immediately prior to transportation and transmission is identical with the language originally enacted in 1985. *See* also W. Va. Code § 11-13A-2(c)(6)(G) (1995 Replacement Vol.).

compression, processing, and transmission or transportation costs, as well as a host of additional expenses, in the property tax structure. But, the Legislature chose not to do so.

The Legislature had two obvious opportunities to duplicate the Severance Tax deductions that CNX desires in the property tax structure. First, the Legislature promulgated the current legislative rule for the ad valorem property tax for producing oil and gas wells in 2005. *See* W. Va. Code R. § 110-1J-1.4 (effective date of January 1, 2005). The legislative rule for the Severance Tax was promulgated by the West Virginia Legislature in 1992; thirteen years beforehand. If the Legislature had wanted to authorize similar deductions for post-production expenses for ad valorem tax purposes, it would have been a simple matter of copying the deductions from the statutes or the legislative rule for the Severance Tax and pasting those deductions into the new legislative rules for ad valorem property taxes.

Second, the Legislature supplemented the general statutory framework for property taxes by enacting a new article of the tax code solely pertaining to industrial personal property and natural resources. *See* W. Va. Code § 11-6K-1, *et seq.*, (2010). Again, it would be a simple exercise to copy the statutory exemptions for transportation and transmission expenses or any other expenses from the Severance Tax and to paste those deductions into W. Va. Code § 11-6K-1 in 2010. But, the Legislature chose not do so.

CNX should not be allowed to claim deductions for property tax purposes that were specifically created under the Severance Tax or the Corporate Net Income Tax. The Legislature could have authorized these same deductions for the property tax framework, but chose not to do so. Different taxes operate differently.

B. THE BUSINESS COURT ERRONEOUSLY CREATED A HYBRID RULE FOR VALUING PRODUCING OIL AND GAS WELLS INSTEAD OF APPLYING THE LEGISLATIVE RULE.

B.1. The Business Court Created a Hybrid Rule.

The Tax Department's second assignment of error is that the Business Court created a Hybrid Rule rather than applying the legislative rule for producing oil and gas wells. CNX argues:

> Furthermore, the Tax Department's argument that the Circuit Court created a "hybrid rule" is confusing. Apparently, the Tax Department is basing the characterization on language that this Court used in *Lee Trace, LLC v. Raynes*, 232 W. Va. 183, 751 S. E. 2d 703 (2013). In that case, use of the term "hybrid" was logical, since the Berkeley County Board of Equalization and Review had required the assessor to use both the cost approach and the income approach to determine the appraised value of an apartment complex. The Circuit Court did no such thing in this matter, and instead applied the Rule as written without allowing the unlawful "cap."

CNX's Supreme Court Brief at p. 20. CNX has ignored the similarities between the Business Court's Hybrid Rule and the *Lee Trace* decision issued by this Court. *See Tax Department's Supreme Court Brief* at pp. 18-19. *Lee Trace* clearly states that producers are not permitted to re-write the valuation methodology; the Business Court is not permitted to re-write the applicable legislative rule and is prohibited from creating a Hybrid Rule.

CNX argues that the Business Court did not create a Hybrid Rule but instead determined the fair value of CNX's producing oil and gas wells by deducting an **unlimited** 20% of gross receipts. The Business Court's Hybrid Rule adopted CNX's argument and rejected the Average Annual Industry Operating Expense as determined by the Tax Department. *See CNX's Supreme Court Brief* at p. 4-5 and 15, 16, & 19.

The Business Court's Hybrid Rule re-wrote the legislative rule stating that the rule "... contemplates a single average which the Tax Department has calculated as 30 percent of gross receipts..." *See* Business Court Decision at AR 0006. In its Supreme Court Brief, CNX Gas argues

in support of the Business Court's revised language for the legislative rule. *See CNX's Supreme Court Brief* at p. 15-16. The Business Court ruled and CNX argues that the not to exceed amount of $5,000 per well is a "cap" which is not authorized by the legislative rule. *See* Business Court Decision at AR 0006 and *CNX's Supreme Court Brief* at p. 15-16.

However, the language in the legislative rule is clear.

> 4.3. Average industry operating expenses. -- The Tax Commissioner shall every five (5) years, determine the average annual industry operating expenses per well. The average annual industry operating expenses shall be deducted from working interest gross receipts to develop an income stream for application of a yield capitalization procedure.

W.Va. Code R. § 110-1J-4.3. The definition for Average Annual Industry Operating Expenses does **not** include the term "single average." Nor does the legislative rule include the word "percentage"; the Business Court has also read the word "percentage" into the legislative rule. The Business Court has created an express requirement that the Average Annual Industry Operating Expenses must be expressed **only** as a percentage. The new requirements created by the Business Court are contrary to both the legislative rule and common sense. As Cindi Hoover testified, *supra*, the $5,000 not to exceed amount is the dollar amount of the average expenses reported by the producers. In addition, the producers reported their operating expenses on the industry survey as dollars not percentages. Therefore, the most logical way to express the Average Annual Industry Operating Expense would be in terms of dollars and not percentages as ruled by the Business Court.

The Tax Department exercised its discretion to express the Average Annual Industry Operating Expense as both a percentage of gross receipts and an absolute dollar amount. The Business Court has failed to respect the Tax Department's discretion in interpreting a statute and applying a legislative rule. See Syl. Pt. 5, *In re Assessment Against American Bituminous Power*

Partners, L.P., 208 W.Va. 250, 539 S.E.2d 757 (2000) (The exercise of discretion granted to the Tax Commissioner will not be disturbed upon judicial review absent a showing of abuse of discretion).

Significantly, CNX Gas has made a telling admission in Footnote 55. CNX states that the legislative rule "...does not expressly address 'actual operating expenses'" when valuing producing oil and gas wells. Despite this admission, CNX has premised its entire argument on the failure to utilize its "actual operating expenses" for ad valorem property tax purposes. As argued previously by the Tax Department, the only deduction authorized under the legislative rule is the Average Annual Industry Operating Expense as determined every five years. *See* W.Va. Code R. § 110-1J-4.3.

By creating a Hybrid Rule, the Business Court re-wrote the language in the legislative rule. The Business Court substituted its judgment in place of the Tax Department's judgment regarding whether to express the Average Annual Industry Operating Expenses as both a percentage and a not to exceed amount. The Business Court has inserted words into the definition of Average Annual Industry Operating Expenses contrary to well established law. The Business Court's Hybrid Rule has crossed the same boundaries that the Supreme Court stated could not be crossed in *Lee Trace*.

B.2. The Business Court Decision in Denex Petroleum Corporation Cited by CNX Supports The Tax Department's Argument.

CNX argues that the Tax Department has taken contradictory approaches to valuing producing oil and gas wells and cites to the Tax Department's *Response to Petitioner's Brief* filed September 29, 2016 in *Denex Petroleum Corporation v. Mark W. Matkovich, West Virginia State Tax Commissioner, et al.*, Civil Action No. 16-AA-1, Barbour County. CNX's specific objection

is that the Tax Department argued in its brief that Denex Petroleum had failed to submit its actual operating expenses for review. *See CNX's Supreme Court Brief* at Footnote 55.

In *Denex*, the Business Court, The Honorable Christopher C. Wilkes Presiding Judge, ruled that the Tax Department correctly applied the legislative rule for traditional oil and gas wells by allowing the Average Annual Industry Operating Expense of "...30% of gross receipts derived from production, not to exceed $5,000." *Denex* at p. 4, Finding of Fact 9. Denex argued that "...its actual expenses due to their static nature coupled with falling gas prices are more than the allowed deduction." Denex also argued that it should be allowed to deduct transportation expenses related to an agreement Dominion Gas. *Denex* at p. 4, Finding of Fact 10.

Denex Petroleum supports the Tax Department's position. First, although the Business Court Decision did not specifically address this issue, Denex's primary argument was that it should be allowed to value some of its producing oil and gas wells at three times net receipts. *See* Tax Department's *Response to Petitioner's Brief* filed September 29, 2016 at p. 3, Statement of Fact 9. In addition, the Business Court Decision did not address whether the Tax Department could or should review the actual operating expenses for the corporation. Second, Denex failed to participate in the 2014 survey and failed to respond to the public comment period for the valuation variables for the 2016 TY. *See* Tax Department's *Response to Petitioner's Brief* filed September 29, 2016 at Statements of Fact 15-18. Third, Denex Corporation failed to produce its actual operating expenses for review at the Board of Equalization and Review hearing. The Business Court ruled that Denex demanded a reduced valuation based on its own calculations which was at odds with the legislative rule. *See Denex* at p. 7. Significantly, the Business Court ruled that the Tax Department had no discretion to utilize any valuation methodology other than the Yield Capitalization Model in the legislative rule. *See Denex* at p. 9.

C. THE LEGISLATIVE RULE DOES NOT VIOLATE THE EQUAL AND UNIFORM CLAUSE OF THE WEST VIRGINIA CONSTITUTION OR THE EQUAL PROTECTION CLAUSE OF THE UNITED STATES CONSTITUTION.

CNX argues that the Tax Department has violated the equal and uniform clause of the West Virginia Constitution in valuing CNX's producing oil and gas wells. In its previous Supreme Court brief, the Tax Department gave the example of two families of four filing their West Virginia personal income tax returns in order to illustrate the Business Court's failure to appreciate the way deductions and exemptions work in the tax code. The Tax Department argued that each family claimed a "standard deduction" of $2,000 per person in filing the tax returns. *See Tax Department's Supreme Court Brief* at pp. 25-26. CNX objected and argues the example is erroneous because "... the personal exemption has *zero relationship* to expenses incurred by the personal income taxpayer, and is not a standard deduction." *See CNX's Supreme Court Brief* at Footnote 58 (emphasis in CNX's brief); *see* also W. Va. Code § 11-21-16(a).

CNX is correct; the Tax Department erroneously used the term "standard deduction." The correct illustration is that the first family makes $1 million while the second family earns $20,000. Both families claim personal exemptions of $8,000 for a family with four dependents. The first family that earns $1 million must pay income tax on $992,000 while the second family pays income tax on only $12,000 of income. The first family pays income tax on 99.2% of its income while the second family pays income tax on only 60% of its income. Both families pay tax on a different percentage of income while receiving the same personal exemption. The Average Annual Industry Operating Expense deduction in the legislative rule for producing oil and gas wells works exactly the same way. Neither the income tax nor the ad valorem property tax creates an equal and uniform problem or an equal protection issue.

However, CNX has missed the larger point. Deductions and exemptions are a matter of legislative grace. *See Shawnee Bank v. Paige*, 200 W.Va. 20, 27, 488 S.E.2d 20, 27 (1997). Regardless of whether the Legislature enacted a personal exemption or a standard deduction, the two families are taxed on a different percentage of their income. One family pays income tax on 99.2% of its income while the second family pays tax on 60% of its income. CNX is in the same boat as the first family because the Legislature has chosen a specific standard deduction for the ad valorem property tax structure. The end result is the same.

II. CONCLUSION

The Tax Department valued all of CNX's producing oil and gas wells in Doddridge County correctly under the legislative rule. The Tax Department utilized the standard deduction of the Average Annual Industry Operating Expense as required by the legislative rule. Rather than apply the legislative rule, the Business Court focused on expenses which are not a proper deduction under the legislative rule and created a Hybrid Rule which is contrary to the Supreme Court's decision in *Lee Trace, LLC v. Raynes*, cited *supra*. The Supreme Court should reverse the Business Court decision and reinstate the proper ad valorem valuations as determined by the State Tax Department.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, L. Wayne Williams, Assistant Attorney General, do hereby certify a true copy of the *Reply Brief of West Virginia State Tax Department* was served upon counsel for the Respondent via United States Postal Service, first class, postage prepaid, thereof this 23rd day of July, 2018, addressed as follows:

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